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INDIA: ECONOMIC LIBERALIZATION STALLED 25X1

Summary

The momentum of Prime Minister Gandhi's policy efforts to ease bureaucratic controls on Indian foreign trade and industrial production has stalled. US business opportunities that were opened by Gandhi's earlier liberalization moves have not yet been closed, but within the next two years we believe that there is a moderately high risk that Indian policymakers, fearing balance of payments strains, will impose import restrictions. 25X1

Although the private sector still benefits from liberalization moves that began in 1980, New Delhi merely tinkered with the regulatory system during the past year. Policymakers raised already-high import tariffs and threatened to use the government's extensive shareholdings to intervene more actively in the management of large private corporations. Earlier policy moves providing easier access to foreign goods and technology have not accelerated Indian exports or industrial production. 25X1

The policy experiment with liberalization is not yet over. A vague preference for shifting away from detailed direct controls is likely to continue alongside a consensus that the central government is responsible for directing the overall pattern of economic growth. 25X1

This memorandum was prepared by Subcontinent Branch, South Asia Division, Office of Near Eastern and South Asian Analysis. Information as of 3 August was used in its preparation. Questions and comments should be directed to Chief, South Asia Division, 25X1 25X1

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Trade and Industry: Selected Policy Measures since June 1983

July 1983	*Licenses to manufacture machine tools may be issued for product categories rather than individual items.*	*Example of procedural liberalization while retaining control mechanism.*
	Specifications for global tenders should be framed to favor Indian suppliers of capital equipment for use in 13 industries including electronic components, petroleum exploration, fertilizer, and cement. Government permission required before issuing global tenders for power-generating equipment.	*Protects domestic manufacturers. If implemented aggressively, will mark major backsliding from 1978 liberalization measure.*
August 1983	*Import duties on electronic components and excise duty on consumer electronics and computers lowered. Government minister hints at easing of output restrictions on domestic manufacturers.*	*Signals government support for domestic electronics industry, previously viewed as luxury. According to press speculation, government expects spillover of technical skills to benefit defense electronics and political gains from greater use of television.*
October 1983	*Central government took over management of 13 Bombay textile mills, which had been idled by extended strike.*	*Probably does not portend further nationalizations.*
	Import duty on textile machinery substantially reduced if manufacturers export 75 percent of additional production.	*Prompted by inability to fill EC textile quotas because of high cost and low quality. Government may have difficulty enforcing export obligation.*
December 1983	*Amendment to antimonopoly legislation introduced. Extends scope of restrictive controls to storage, distribution, and investment activity; limits previous easing of restrictions on growth; empowers government to seek splitup of large companies.*	*Passed in May 1984. May have been intended merely to close loopholes in existing legislation. Viewed by some industrialists as major reversal of previous liberalization.*
	Exports of low-grade tea banned.	*Curbed domestic price rise. Reflects continuing priority for meeting basic consumption requirements over increasing export earnings.*
January 1984	*Unused letters of intent (preliminary government permission to establish industrial capacity) may not be renewed.*	*Probably intended to curb abuse of existing procedures. Some industrialists had requested manufacturing rights only to preclude production by potential competitors.*
February 1984	*Central government budget: general hike in import duties, additional protection for steel products, tax cuts to help a few export industries.*	*Tax increases are primarily revenue measure, may also reflect growing concern about possible future balance-of-payments strains.*
February-March 1984	*Right of government financial institutions to convert their loans to private corporations into equity: "convertibility clause" no longer required for loans below $4.7 million, those for use in areas without industry, or when government already holds 26-percent equity in smaller companies.*	*Restricts previous potential for government control. Business fears of government intervention in corporate management nevertheless heightened by reaffirmation of policies for large or mismanaged corporations.*
March 1984	*Private sector permitted to manufacture telephones and data communications equipment. Previous permission for minority private equity in manufacture of switching and transmission equipment reaffirmed.*	*Limited opening of telecommunications industry to private sector probably reflects government shortage of investment funds and recognition of deficiencies of current communications.*
	New guidelines mandate more active government role in management of private corporations.	*Government institutions hold substantial equity in many large corporations, but until recently rarely intervened in management of healthy units. Some businessmen now fear political favoritism.*
April 1984	*Import-export policy: eased capital good imports for gem, textile, and electronics industries; tightened control on steel and some chemicals. Value ceiling on technical drawings raised. Import privileges for some exporters slightly increased.*	*Marginal changes preserve most previous liberalization of direct controls. Continued reliance on exemption from import restrictions to encourage exports.*

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Earlier Liberalization Moves

Prompted by dissatisfaction with past economic performance and by interest in the potential benefits of advanced Western technology, Prime Minister Gandhi, after her return to office in 1980, made a multitude of relatively minor policy changes in India's extensive system of direct controls. She eased the stranglehold of bureaucratic controls on industry and provided a more favorable climate for private investment. Gandhi opened new opportunities for Indian industry to become more efficient by:

- Simplifying import licensing procedures, especially those that impede exports;

- Removing many legal impediments to growth of imports and production, especially for export industries;

- Encouraging technical cooperation with Western business and authorizing izing increased use of foreign commercial loans. [redacted] 25X1

Recent Foreign Trade Policies

Momentum toward decontrol of foreign trade has been lost during the past year, even though most past liberalization measures remain in place and New Delhi is still trying to stimulate exports of manufactured goods. The few changes that eased access to import licenses during the year were apparently intended to assist specific industries that the government wants to promote. Many of the export policy adjustments, in contrast, were broad-based in an attempt to reenforce incentives for somebody to discover something India can sell. [redacted] 25X1

25X1

[redacted]

Export Policy. New Delhi's export promotion strategy remained closely linked with import controls. The annual trade policy, announced in April, raised the value of import licenses that can be obtained as a reward for foreign sales, but imposed a few new restrictions on their use. Domestic firms obtained new permission to import textile machinery and computer hardware but must accept an obligation to export a large share of their textile or software production - a requirement that the government may have difficulty enforcing. [redacted] 25X1

The government modified policies that encourage manufacturers and traders to establish facilities that are entirely oriented to the export market. Because previous incentives attracted only a limited response, new regulations permit '100 percent' export firms to sell 25 percent of their production to domestic users who hold import licenses. Such manufacturers will receive priority in the allocation of electricity, telephones, rail freight cars, and other scarce supplies. New Delhi is still experimenting with import privileges for export-oriented trading firms; revised regulations raise the export obligation for businesses established under earlier incentive programs but provide new inducements to set up trading firms that specialize in products of small-scale industry. In addition, the Finance Minister announced plans for four new export processing zones where goods can be imported freely and processed for export. [redacted] 25X1

Increased benefits from tax relief and subsidy programs helped exporters. Some changes during the past year compensated for a hike in domestic taxes on imputs used in the manufacture of export commodities. Others provided relief in the face of slack demand in some foreign markets. According to the World Bank, past export subsidies were less than the tax burden on export commodities; we doubt that recent minor rate changes have increased the net benefits enough to constitute unfair competition in international markets. [redacted] 25X1

New Delhi expanded use of previously minor export promotion tools in response to the financial problems of customers in Eastern Europe and the Middle East. Although Indian Commerce Ministry officials remain reluctant to encourage linked export-import deals, they announced that India will direct its purchasing power toward countries that buy more Indian goods. The Indian government offered additional export credit, particularly large loans for Iraq, in order to rescue Indian contractors and suppliers and enable them to continue sales even though their customers could not pay. [redacted] 25X1

As in previous years, New Delhi was reluctant to push agricultural exports at the risk of domestic shortages. Policymakers banned exports of low quality tea from late December 1983 through mid-May 1984 in a successful effort to curb domestic price increases. New contracts to export cotton were also prohibited after the crop was reduced by pest damage. [redacted] 25X1

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Import Restrictions. Minor changes marked some progress and some retreat from a major aspect of Gandhi's liberalization -- import licensing controls. During the past year, exporters and newly-favored industries such as electronics benefitted from increased access to imported capital goods. Importers gained greater freedom of choice as a result of proceedural changes that extend the validity of import licenses and require government import agencies to respond more quickly to requests from domestic users. However, imports that could threaten steel and chemical manufacturers will be more tightly scrutinized. 25X1

The overall import regime probably became slightly more restrictive, in our view, as a result of changes other than licensing. Most import taxes were raised by five percentage points above already-high levels -- a revenue measure which increases import barriers -- and some steel producers received renewed tariff protection. In order to stimulate domestic production of oil exploration equipment, New Delhi announced that it will buy from Indian manufacturers even if they charge higher prices than bid by foreign suppliers; price preferences will be scaled to favor manufacturers who minimize the import content of their production. Potentially more disturbing, an administrative ruling requires that the technical specifications in global tenders be slanted to favor domestic producers. 25X1

Foreign Investment Policies. A boom in foreign business links is underway even without any further policy changes. New Delhi approved 673 collaboration agreements in 1983, substantially more than in the past. Almost all provide for some type of transfer of technology from foreign to Indian firms. Less than 20 percent entail equity investment. Gandhi has not been swayed by rising press criticism that India is wasting foreign exchange on imports of 'screw-driver technology.' 25X1

Recent Industrial and Corporate Policy Changes

Private industry gained new freedom from restrictions on output during the past year, but the slight easing of industrial licensing was overshadowed, in our view, by confrontation between government and large corporations. New legislation was introduced in December to close loopholes that businessmen has exploited to avoid government controls. The traditional battle of wits and payoffs moved to a new arena as government financial institutions tried to use their extensive shareholdings in a political vendetta and planned for more general management control. 25X1

Licensing Restrictions. Smaller firms and some high technology industries gained new production opportunities as New Delhi continued to relax the regulations that make it illegal to expand production beyond limits specified in industrial licenses. The control system was amended to renew permission for automatic increases in capacity and simplify proceedures. Private firms are now

allowed to produce some drugs and telecommunications equipment that had been reserved for the public sector. When announcing tax concessions to stimulate the electronics industry, the Deputy Minister for Electronics implied that large scale private production would be permitted. 25X1

Prime Minister Gandhi continued to temper industrial liberalization with efforts to promote the development of remote areas and to protect small industry. Such policies diminish business freedom and often increase production costs. Controls were amended during the past year to reserve additional items for production exclusively by the small-scale sector and to increase subsidies for investment in districts without any industry. Press reports allege that industrial licenses -- and subsidies -- have been granted more readily for production in areas where Prime Minister Gandhi's party needs support than for other underdeveloped areas. 25X1

<u>Battling Large Companies.</u> The bureaucracy remained ambivalent during the past year about implementing policies that regulate big corporations. According to press reports, some companies were freed from the rigors of anti-monopoly legislation when officials informally changed the definition of market dominance. On the other hand, some of the multiple ministries whose approval is required refused to honor formally announced exemptions from controls on large companies. Officials used their discretionary authority to curb business abuse of the industrial license system -- they refused to renew unused licenses when they believed that the applicant sought only to preempt production rights that might have been granted to competitors. 25X1

Many businessmen view amendments to corporate law and anti-monopoly legislation as a major reversal of Gandhi's policy of liberalizing restrictions on domestic industry. New legislation, passed in May, limits the right of corporations to choose their own management, and empowers the government to split large companies into smaller ones. It extends the scope of previous anti-monopoly laws and reimposes some restrictions on output of large companies. These amendments emerged from long-planned efforts to revise outdated rules and curtail egregious abuses by some large companies; we believe they were originally intended to clarify poorly-drafted legislation, not to change policy substantially. According to press reports, however, the final legislation, will double -- to about 3000 - the number of companies subject to anti-monopoly legislation that restricts business freedom to expand production. Age restrictions on corporate directors, if enforced, will oust several leading industrialists who support opposition political parties from their management positions. 25X1

<u>Use of Government Shareholdings.</u> Business concern about government interference in the private sector heightened significantly during the past year. Bitter controversy resulted from official efforts to exploit the economic power inherent in government shareholdings:

- o Government financial institutions have long held stock in hundreds of private corporations -- more than half the shares of a few companies, more than a quarter of many others. Some ownership was acquired through conversion of development bank loans into equity; most results from the investment and market operations of nationalized insurance companies and of a huge government mutual fund. Until recently, the institutions rarely intervened in the management of viable companies.

- o Probably proded by central government ministries, the institutions began to play an active role in a very few companies during early 1983. Most conspiciously, they attempted to support a bid to take over two of India's leading companies by Swraj Paul, a London based businessmen who has family business interests in India. According to press reports, the chairmen of the Indan companies favor opposition political parties, while Paul openly supports Prime Minister Gandhi and allegedly helps arrange payments from foreign businessmen for her Congress (I) party. The battleground for the major takeover bid shifted to the courts in late 1983.

- o In March, 1984, the Finance Minister announced new guidelines that specify an active role for directors who are nominated to the boards of large companies by the financial institutions. They will be expected to supervise inter-corporate investments and the awarding of large contracts, curb lavish expenditure and ensure that government loans are repaid. As a concession to business fears, the financial institutions will forego the option of converting loans into equity when loans are small or government shareholding in smaller companies is already substantial. 25X1

These moves do not signal a general anti-business turn in government policies, in our judgment. Senior civil servants have gone out of their way to assure businessmen that no precedent has been set by government efforts to assume management control of a few companies. Smaller companies are now less vulnerable than before to government intervention. The new guidelines reflect, in part, recommendations of non-political commissions that studied the role of the financial institutions in the increasingly important stock market. 25X1

Large corporations nevertheless have reason to fear that government shareholding may be misused to reward friends and punish foes of the party in power. In our view, political intervention was almost certainly a factor in the Swraj Paul fracas. Although the Finance Minister insisted that the financial institutions would not displace managements with a good track record, he also contended that hereditary control is itself a sign of a poor track record. Many of India's giant conglomerates are still controlled by relatives of their founders, even though familiy ownership has diminished and management is becoming increasingly professional. 25X1

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Economic Impact of Liberalization

Four years of easing detailed economic regulations have not yet stimulated Indian exports or industries. Manufacturing output grew only slightly in the past two years even though import licenses for essential industrial equipment could be obtained without great difficulty. An inflow of foreign technology has not yet helped nonoil exports, which fell in FY 1982/83 and remained depressed last year. 25X1

In our judgment, this indifferent performance reflects, in part, the limited extent of decontrol and the time lags between policy changes and results. It also indicates that economic liberalization alone is insufficient to stimulate the economy because businessmen cannot take advantage of new freedom when electricity shortages and labor unrest hamper production. They cannot expand exports when foreign buyers are short of funds or sell more at home when poor weather limits the purchasing power of farmers. 25X1

The recent stall in liberalization has barely affected private investment plans. A few leading business houses have reportedly begun to postpone or drop new projects rather than borrow from government financial institutions. However, we do not yet detect any widespread shift in corporate expansion plans in response to fears of greater government intervention in private management decisions. According to press and Embassy reports, business spokesmen are relieved that most past liberalization measures remain in place and are only mildly disappointed by the loss of momentum toward further decontrol. 25X1

Policy Prognosis

We believe the Indian experiment with liberalization is not yet over. Prime Minister Gandhi and her economic advisers -- along with most segments of business and political opinion - would still like to ease the bureaucratic stranglehold on Indian industry. They also believe that the central government must remain responsible for directing the pattern of economic growth. Once election year politics are over and the benefits of past decontrol measures become clearer, any new government will probably reassess policy options for combining government control with more business freedom. In our judgment, the pace of further liberalization will be determined largely by India's international financial position and by the ability of government and big business to reach a new accommodation. 25X1

Balance-of-Payments Strains. We see a moderately high risk that Indian policymakers will tighten foreign trade controls within the next two years, even though they would prefer to relax restrictions on imports and import-using industries. Several official sources hint that imports will be curbed during the Seventh Plan (1985-1990) to help cope with an expected decline in concessional aid and mounting debt service payments. Senior officials have indicated that

they are prepared to sacrifice growth rather than risk international debt problems by accelerating commercial borrowing. According to press reports, policy advisers are still debating whether higher import tariffs or tighter licensing controls are the least undesirable method of import restraint. [redacted] 25X1

Policymakers would probably not extend decontrol efforts just to stimulate exports of manufactured goods. During the earlier phases of liberalization, New Delhi hoped that easier access to imports would make a wide range of Indian industries more competitive in world markets. Now, press reports indicate growing pessimism about export prospects even for industries no longer constrained by a shortage of imports. In addition, Indian export promotion strategy may unintentionally entrench the underlying system of import and industrial restrictions; exporters are now rewarded with exemption from controls that are imposed on others and would lose their preferential position if all controls were relaxed. [redacted] 25X1

<u>Business-Government Accommodation.</u> In the longer run, New Delhi is likely to dismantle its elaborate regulatory system only if policymakers become confident of their ability to direct the pattern of economic growth without the detailed controls of past years. Official and private analysts are now actively searching for new policy strategies. A widely-respected former civil servant heads a committee that is studying the feasibility of achieving social goals through control of the banking and investment system rather than through licensing restrictions on output and imports. Many observers counsel a shift in central government planning to allow greater scope for state government and private initiatives. [redacted] 25X1

The current battle between corporate and political leaders will contribute to the evolution of new and less restrictive policy strategies if it helps reestablish an informal understanding about the tolerable limits to corruption and management freedom. At present, plans to supervise the corporate sector through financial institutions are contaminated by political favoritism and create new opportunities for government interference. These plans also provide a new tool for regulating economic growth that could eventually make policymakers less reluctant to ease detailed controls on private industrial output. We are uncertain which outcome will dominate. [redacted] 25X1

Implications for US Business

US business opportunities that were opened by Prime Minister Gandhi's earlier policy moves have not been closed by the recent stall in liberalization. Official interest in high-technology imports remains strong. Measures to protect domestic producers now sometimes extend to their foreign associates. Recent industrial decontrol efforts have been less comprehensive than in the past, but are in industries where additional foreign collaboration is anticipated. Nothing in the current feud between the central government and Indian corporate giants suggests that greater government intervention in private management would be used

to curb links with foreign businesses. Even a new wave of anti-monopoly moves within India would leave ample opportunities for US firms to deal with medium- and small-scale Indian businesses. Policymakers' adversion to balance-of-payments risk, however, may lead to renewed import controls that would restrict US export opportunities. 25X1

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